

**PROMOTING NATIONAL COMPETITIVENESS IN A GLOBALIZING ECONOMY:  
THE STATE'S CHANGING ROLES**

by

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Globalization has, for more than two decades, been changing the “rules of the game” for nations competing in international trade and investment. The roles of the state as a central planner and controller of the national economy, as the primary provider of goods and services, and as the engine of economic growth, have largely been discredited as effective functions for governments seeking to promote national competitiveness in a global economy. Indeed, even the ability of states to exercise sovereign control over internal economic activities and transactions across their borders has weakened in the face of relentless globalization.<sup>1</sup>

Governments in countries seeking to participate effectively in global economic competition must increasingly assume new roles -- as catalysts for market development, enablers of productivity and efficiency, regulators ensuring that markets remain open and equitable, promoters of private sector expansion, and stimulators of human and capital resource development. They must use their resources to provide services and infrastructure that make productive activities competitive nationally and internationally. In a global economy, governments must work cooperatively with the private sector, civil society organizations, international financial institutions, and public interest groups to develop institutions that support and sustain market systems through which enterprises of all sizes engage in regional and global

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trade and investment. Although governments in many countries with developing and transitional economies are transforming their roles, not all states have successfully abandoned traditional functions and embraced those needed to promote competitiveness.

Globalization is the movement toward greater interaction, integration and interdependence among people and organizations across national borders. The strongest manifestation of globalization has been the increasing economic interactions among countries in trade and investment and in the international flows of capital, people, technology, and information.<sup>2</sup> But globalization is also evident in the increasing levels of international political interaction and widespread social and cultural interchange that have occurred over the past quarter of a century.<sup>3</sup>

Globalization has brought both benefits and challenges to countries around the world.<sup>4</sup> Globalization brings not only new economic opportunities but also new political, social, technological, and institutional complexities, especially to poorer countries, that governments must address in order to stimulate economic competitiveness while pursuing equity, sustainability, and poverty alleviation. In order to benefit from more open and widespread economic interaction states must create and support an economic system that promotes and facilitates the ability of business enterprises to compete effectively in international markets.

This paper examines the changing roles of the state in promoting and supporting national competitiveness in an era of globalization. It explores the concepts of globalization that government policies should reflect in order to redefine the state's role in promoting participation and competitiveness in the international economy. It describes the forces driving integration of regional and global economies, the factors that contribute to a nation's economic

competitiveness, and the policy and institutional components of a national competitiveness promotion strategy.

## **GLOBALIZATION BRINGS NEW CHALLENGES FOR GOVERNMENTS**

Globalization is the hallmark of the 21<sup>st</sup> century. Since the early 1980s the economy has been globalizing at a rapid pace -- markets for goods and services have been expanding internationally, countries have been forming regional and global trading partnerships, and corporations have been expanding regionally and doing business worldwide. Few enterprises in any country that seek to survive and grow can ignore global markets.

### **Globalization and Economic Growth**

In a global market individuals, households, and businesses trade with each other within and across national borders. Although a globalizing economy is subject to cyclical spurts of growth and periodic downturns, much like the cycles of domestic economies, the world economy has grown rapidly since the 1960s. Although regional recessions in Latin America in the early 1980s, in Africa in the 1980s and 1990s, and in Asia in the late 1990s -- and the worldwide recession beginning in 2000 -- temporarily dampened the pace of economic globalization, they did not reverse it. Despite cyclical downturns, globalization drove world economic growth by 140 percent (in real US dollars) between 1970 and 1998 to nearly \$40 trillion in annual output of goods and services.<sup>5</sup>

The most recent surge of economic globalization, beginning at the end of World War II and accelerating in the early 1980s, was driven first by trade (exporting and importing), then by foreign direct investment (inward and outward purchases of productive assets), and now by both pervasive trade and investment accelerated by technological advances in communications and transportation. International trade grew substantially during the last half of the 20<sup>th</sup> century. The

value of world merchandise exports doubled from a little more than \$2 trillion in 1980 to a little more than \$4 trillion in 1994, and then increased to \$6 trillion in 2001.<sup>6</sup> The ratios of merchandise exports to GDP grew from about 8 percent in 1960, to 13 percent in 1990, and to nearly 18 percent in 1998. In addition, the value of world exports of commercial services increased from \$402 billion in 1980 to more than \$1.4 trillion in 2001.

These trends generally held for both developing countries and advanced market economies. Between 1990 and 2000, trade in goods as a percentage of world GDP increased from 32 percent to 40 percent. Countries at all levels of income, on average, increased their participation in international trade and foreign direct investment (FDI). Gross FDI also increased as a percentage of GDP worldwide from 2.7 percent to 8.8 percent.<sup>7</sup> The economic growth of many developing countries has been closely associated with the shift from inward-looking protectionist development strategies to outward export-oriented liberal trade strategies. Those countries that have diversified their exports and opened their economies to imports and investment have grown faster than countries that maintained protectionist policies or that continued to export only basic commodities and raw materials.<sup>8</sup> Although developing countries engaged in a smaller volume of trade than did richer countries, the value of their exports more than doubled from 1980 to 1994. The manufacturing export shares of developing countries increased from about 5 percent in 1913 to nearly 25 percent in 1994. By 2000, developing countries accounted for 30 percent of merchandise exports.<sup>9</sup> And all regions of the world saw growth in manufactured exports, although countries within regions differed drastically in their rates of growth.

By the 1990s, economic globalization was being driven more by foreign direct investment (FDI) than by trade. Total world inward and outward FDI grew from 10 percent of

world GDP in 1980 to 31 percent in 1999. The accumulated stocks of inward FDI increased from about \$14 billion in 1914 to about \$2.5 trillion in 1995, and to more than \$6.8 trillion in 2001.<sup>10</sup> Both trade and investment were driven by the expansion of transnational corporations (TNCs). Between 1996 and 2001 the number of parent TNCs grew from 44,000 to more than 65,000 and their number of foreign affiliates (enterprises in which they had a 10 percent or more investment) increased from 280,000 to 850,000. The sales of foreign affiliates doubled during the same period from \$6.4 trillion to \$18.5 trillion, growing to twice the size of world exports. The total assets of TNC's foreign affiliates grew from \$8.3 trillion in 1996 to nearly \$25 trillion in 2000. The gross product (value of output) of TNC parents and affiliates grew to \$8 trillion in 1999, accounting for about 25 percent of world GDP. Foreign affiliates of TNCs now employ more than 53 million people.

### **Benefits of Globalization and Market Competition**

Most international economic studies conclude that the shift toward a more competitive global economy that accelerated in the early 1990s, and the opening of more countries' markets to world trade and investment over the past 50 years benefit not only richer nations but also developing countries that open their markets and those in transition from government-controlled economies to market systems. The Organization for Economic Cooperation and Development (OECD) concludes that countries that opened their markets to international trade and investment have achieved double the average economic growth of those that did not.<sup>11</sup> A broad range of studies conclude that the economies of countries that had open markets and participated in international trade and investment have grown faster than those that constrained their domestic markets and limited their participation in international trade.<sup>12</sup> Growth in gross domestic product (GDP) is positively associated with export growth. Growth rates are generally higher for all

subgroups -- small and large primary goods exporters and small and large manufacturing exporters -- in outward-oriented countries. Open market economies have higher investment ratios, better macro-economic balance, and stronger private sector roles in economic development than do non-market countries.

Recent criticisms of globalization for rewarding economic competitiveness at the cost of social progress overlook the substantial improvements in social conditions around the world during the period of rapid population growth and economic integration. Overall, social conditions and quality of life indicators improved in much of the developing world during the last half of the 20<sup>th</sup> century. The United Nations Food and Agriculture Organization reports that by 2000 global agricultural production increased 1.6 times greater than the total production level achieved in 1950, which in that year was the highest in 10,000 years of agricultural history.<sup>13</sup> Between 1970 and 2000, infant mortality (per 1,000 live births) dropped in Sub-Saharan Africa from 132 to 92, in East Asia and the Pacific from 77 to 35, in South Asia from 138 to 75, and in Latin America and the Caribbean from 82 to 31.<sup>14</sup> The United Nations Development Programme's *Human Development Report* indicates that since 1990, 800 million people obtained improved water supplies and 750 million gained access to improved sanitation. Primary school enrollments worldwide increased from 80 percent in 1990 to 84 percent in 1998. Countries in which half the world's population lived have reduced hunger by 50 percent or are on track to doing so.<sup>15</sup> About 81 countries moved significantly toward democracy, and more countries than ever before -- 140 of the world's nearly 200 nations -- held multiparty elections. Analyses of the relationship between economic progress and "economic freedom" based on rankings of market characteristics -- openness of trade policy, fiscal burden of government, government intervention in the economy, property rights, and others -- have found a strong positive correlation between

the two sets of indicators. Countries with high levels of economic freedom had higher per capita incomes, while those characterized as “mostly unfree” and “repressed” had lower per capita incomes.<sup>16</sup>

The OECD’s studies also indicate that freer and more open market economies can bring both economic and social benefits to countries at all levels of development. Among the potential benefits are: 1) greater freedom of choice for individuals about what to buy and sell and at what price, where to obtain inputs, where and how to invest, and what skills to acquire; 2) comparative advantages in world trade that allow individuals and businesses to prosper by using their resources to do well compared to others; 3) higher incomes to those employed in jobs producing goods and services for international markets; 4) greater freedom for individuals to engage in specialization and exchange; 5) lower prices and a greater availability of goods and services; 6) opportunities to diversify risks and invest resources where returns are highest; 7) access to capital at the lowest costs; 8) more efficient and productive allocation of resources; 9) greater opportunities for firms to gain access to competitive sources of materials and inputs; and 10) inward transfer of technology and know-how.<sup>17</sup>

### **The Problems of Market- and Policy- Failure**

Globalization, however, does not confer benefits on all countries automatically nor does it generate benefits at no cost. All of the market failures that can occur in domestic economies also appear in the global economy. In reality, markets do not always operate as they are supposed to in theory. When they deviate from fundamental principles, market failures can produce economically and socially undesirable consequences. Market failures appear when consumers and producers do not bear the full costs of their actions, when prices do not reflect social costs and benefits, when consumers are manipulated or misled by advertising or do not

have access to appropriate or sufficient information to make good economic decisions, and when unfair trading practices prevent prices from being set by market signals. Moreover, adjustments in market economies can produce cycles of economic decline, financial crises, and recessions or depressions, casting some groups of people into poverty. Strong inequalities in the distribution of income can put a large segment of the population at economic disadvantage, preventing them from participating in or benefiting from market processes. Some segments of the population – the unskilled, the physically or mentally disabled, the aged, and those suffering from serious health problems, for example -- may not be able to earn sufficient amounts of income to participate at all. Firms acting in their own self-interests may exploit natural or common resources or dispose of their environmentally-harmful wastes without regard for human health or welfare and without paying the costs of the damage to the physical environment, thereby shifting costly burdens to society.

But, often, what are called “market failures” are really “policy failures;” the problems result from either the unwillingness or inability of governments to enact and implement policies that foster and support effective market systems and prevent countries from participating in world trade and investment. One example of policy failure often attributed to worldwide economic competition is widespread inequality in the distribution of wealth and income resulting in high levels of poverty. The United Nations Development Programme’s *Human Development Report*, notes that nearly 3 billion people live in relative poverty on incomes of less than \$2 a day and that more than 1.1 billion people live in absolute poverty on less than \$1 a day.<sup>18</sup> The social impacts of absolute poverty are devastating. In the poorest countries about 20 percent of children die before their first birthday, nearly half of those who survive are malnourished, a significant percentage of the population in poor countries do not have access to clean water,



sanitation facilities, basic health services, or adequate education. Most of those living in poverty do not have the opportunity to participate effectively in a market economy or to benefit from it.

Are globalization and the spread of competitive market economies the causes of abject poverty? World Bank economists argue that, to the contrary, “the current wave of globalization which started around 1980 has actually promoted economic equality and reduced poverty.”<sup>19</sup> The World Bank contends that poverty results not from globalization and competition but, instead, from the inability or unwillingness of governments to create the policy and institutional framework required to participate effectively in global economic interaction. From 1990 to 2000, during a period of rapid globalization and a worldwide shift from centrally planned- to competitive market- economies, the number of people living in absolute poverty on less than \$1 a day actually fell from 1.3 billion to 1.1 billion – or from 29 percent to 23 percent of the population in developing countries -- during the same period when the world’s population was growing rapidly. The share of the population living in deep poverty declined the most in countries and regions with the greatest participation in the global economy and the strongest economic growth rates in East Asia and the Pacific, South Asia, and Latin America and the Caribbean. Absolute poverty declined the least, or worsened, in countries in the Middle East and North Africa, Sub-Saharan Africa, and Eastern Europe with the weakest economic growth.<sup>20</sup>

Studies have consistently found a strong relationship between participation in the global economy and national economic growth.<sup>21</sup> During the 1990s the more globalized developing countries’ economies grew faster than high-income countries, and both grew faster than less globalized developing countries.<sup>22</sup> As the Asian Development Bank points out “the Asian experience shows that growth is the most powerful weapon in the fight against poverty. Growth creates jobs that use labor, the main asset of the poor. As growth proceeds, private sector

employment becomes the major source of economic support for the majority of workers and their families.”<sup>23</sup> Government policies facilitating participation in the global economy and stimulating national economic growth made markets work for the poor by strengthening the assets of the poor so that they could participate more effectively in economic activities. They by provided social and economic services -- education, health services, and water and sanitation facilities – that reduce poverty and services and infrastructure that help expand small- and medium- sized enterprises. Encouraging effective private investment increased the number of jobs and raised labor incomes. By expanding into international markets many East and Southeast Asian and Latin American countries reduced poverty by opening new opportunities for trade of agricultural and industrial goods and services.<sup>24</sup> By getting infrastructure and knowledge to the poor in cities and rural regions, and creating efficient systems of public administration, governments in these regions have fostered both growth and equity and addressed asset inequalities across genders, races, ethnic groups, and social classes to reduce both relative and absolute poverty.

### **What is a Competitive National Economy?**

Many of the political, economic, social and physical ills that are now attributed to globalization plagued the world long before the current cycle of globalization began. As noted earlier, during the period of globalization beginning in the early 1980s, many of the world’s economic, social, and political indicators have improved. The problems often attributed to globalization may, in fact, be due to the failure of states to create the competitive national market systems that allow individuals and organizations to participate effectively in global trade and investment

What, then, are the characteristics of national competitiveness that governments need to do to foster and support? The InterAmerican Development Bank points out that national

competitiveness is the quality of the economic environment for investment and for increasing productivity.<sup>25</sup> Macroeconomic stability allows a country to integrate with the international economy. A competitive national economy is based on an open, efficient, and effectively operating market system. A market economy, in its purest form, is one in which individuals and business organizations decide which goods to produce and services to offer, how much and when to produce, and how much to charge for those goods and services, based on market signals without direct interference by non-market institutions.<sup>26</sup> In order to maximize profits, individuals and businesses continually adjust these decisions in response to consumer demands. Prices offer consumers information about how much money they must sacrifice to obtain products or services, and they give producers estimates about the amount of revenue they can earn from their sale. Prices also tell producers the costs of factors of production – technology, labor, raw materials, and capital – that help determine their profit margins.

In a competitive market, economic decision-making is highly decentralized. The market operates through laws of supply and demand. Supply is the number of units of a product offered for sale; demand is the number of units that consumers are willing to buy at a given price. When demand exceeds supply, prices generally rise; when supply exceeds demand, prices generally fall. The market “clears” when supply and demand are in balance. When they are not in balance, self-regulating mechanisms (the “invisible hand”) will push producers to adjust either the amount of goods and services offered or the price at which they offer them. Those producers who do not adjust prices or output cannot compete with other producers, and will eventually go out of business. Competition among producers requires them to gain comparative advantage through adjustment and innovation. Through innovation they find new methods of production, new

products, new raw materials and inputs, or new ways of organizing to make better products at lower cost.

In essence, a competitive market economy is a process of exchange through which individuals, households, and businesses -- acting in their own perceived interests -- exchange money, factors of production, goods, and services. Distribution depends on participants' ability to earn income; that is, for individuals or households to obtain money by selling their labor or by earning interest and dividends on investments, and for business organizations to earn revenue from the sale of goods and services. When a market works effectively it is an extremely efficient means of providing consumers with a wide range of goods and services, creating value and wealth, and allocating resources to their "best uses" in society. The market provides information on prices and values that allow individuals, households, and business organizations to make economically rational decisions. Competition raises the quality of goods and services and lowers prices over time by rewarding participants who act on market signals and by punishing with bankruptcy those who do not. Market expansion generates jobs, providing workers with higher incomes and more resources to consume and save.

The factors or conditions that contribute to a competitive national economy are reflected in the evaluations made by international organizations and transnational corporations. The World Economic Forum, for example, uses a national competitiveness balance sheet that ranks countries on 1) growth competitiveness shaped by information and communications technology, macroeconomic environment, innovation, technology transfer, corruption, and law and contracts; 2) current competitiveness based on sophistication of company operations and strategy and quality of the business environment, and 3) other indicators including technology, public institutions, and macroeconomic environment.<sup>27</sup> Similarly, *The World Competitiveness*

*Yearbook*, published by the Institute of Management Developments ranks the competitiveness of countries on four sets of factors: 1) economic performance, including the soundness of the domestic economy, international trade, international investment, employment and prices; 2) government efficiency, including public finance, fiscal policy, institutional framework, business legislation, and education; 3) business efficiency, including productivity, labor market, finance, management practices, and impact of globalization; and 4) infrastructure, including basic infrastructure, technological infrastructure, scientific infrastructure, health and environment, and value system.<sup>28</sup> The InterAmerican Development Bank points out that a competitive national economy requires financial market development — financial regulation and supervision, information in financial markets, and micro-financing sources; policies that remove barriers to improved labor productivity; efficient infrastructure — good ports and transport, electricity and telecommunications; the capacity to innovate; and effective industrial and investment policies.<sup>29</sup>

Governments have an important policy role in creating conditions that allow these factors to develop or be strengthened within their countries in order to enhance national competitiveness. The United Nations Conference on Trade and Development points out that “the basic policy challenge facing most developing countries remains how best to channel the elemental forces of trade and industry to wealth creation and the satisfaction of human wants.”<sup>30</sup> The World Bank contends that competitiveness and economic growth reduce poverty when countries enact and implement policies based on two pillars of development: “building a good investment climate in which private entrepreneurs will invest, generate jobs and produce efficiently, and empowering poor people and investing in them so that they can participate in economic growth.”<sup>31</sup>

These and other organizations emphasize that although it is private enterprise, and not nations *per se*, that compete in the global economy to create jobs, income, and wealth,

governments play a crucial and pervasive role in fostering, maintaining, and supporting efficient markets through which competition take place. Indeed, the most important roles of the state are to enact and implement market-supporting policies and sustain institutions that encourage and promote efficient economic interaction.

### **THE ROLES OF GOVERNMENT IN FOSTERING NATIONAL COMPETITIVENESS**

The most important roles of governments in an era of globalization are to set the “rules of the game,” and to protect vulnerable groups from the ill effects of market failures. The traditional economic roles of government in a market system are to protect the health, safety, security, and welfare of the population, to establish and enforce fair and equitable rules for market behavior, and to ensure open competition. In order to deal with market failures, governments often intervene in the economy to counter the negative impacts of business cycles, of “free riders,” of social inequities, and of “spillover effects” (i.e., the negative impacts of one group of people or territorial jurisdiction from activities in another).

Although in most cases markets can deliver goods and services efficiently, in some countries and at some times the private sector cannot profitably provide socially valued “public goods.” Personal and national security (police, judicial and penal systems, the armed forces), universal education, health and welfare services, and low-cost housing are often more accessible when they are delivered by governments or nonprofit organizations. Government sometimes play a strong role in the economy when the private sector cannot or will not offer goods or services at affordable prices to a poor population. In a market system, governments can help assure access to opportunity and participation in economic activities, although they cannot guarantee equal distribution of benefits. In most countries governments are also significant purchasers of products and services from individuals, households, and businesses.

The most important roles of governments in fostering and promoting competitiveness in a global economy are: 1) creating an institutional structure for market competition in countries that previously had government controlled, centrally planned economies or nonfunctioning market systems, 2) initiating and sustaining macroeconomic reforms, 3) strengthening legal institutions for economic transactions, 4) enacting and implementing policies that support private enterprise development, 5) improving government efficiency, accountability and responsiveness, 6) providing infrastructure and overhead capital, 7) protecting the economically vulnerable, and 8) strengthening and supporting organizations of civil society.<sup>32</sup>

### **Creating an Institutional Structure for Market Competition**

In order to gain from participation in the global economy, states must create or strengthen their market processes or maintain the efficacy of existing ones. The participation of countries more fully in a global economy depends on their ability and willingness to structure their political, economic, and social institutions to meet the requirements of global market systems.<sup>33</sup> Institutions are generally defined as rules or norms of behavior, the mechanisms that enforce them, and the organizations through which they are applied so that people can interact effectively in conducting economic and social transactions.<sup>34</sup> In a review of development experience in Asia, Chang found that institutional development was one of the crucial factors driving economic growth.<sup>35</sup> East and Southeast Asian countries were able to grow economically and integrate into the global economy through institutions of coordination and administration, institutions of learning and innovation, and institutions of income redistribution and social cohesion.

Creating an institutional structure for market economies and national competitiveness is a long-term process. Market economies developed in Western industrial countries over a period of

more than 200 years. Few developing or transitional countries can pursue all of the changes simultaneously and, in many, a new institutional structure may take generations to put into place. Since the late 1980s, however, governments in countries around the world have been under increasing pressure, both from within and without, to accelerate the process of institution-building to create or strengthen their market economies in order to participate more effectively in the global economy. In order to do so, they must build institutional capacity to support the market attributes described earlier.

Governments often play a crucial role in creating or strengthening institutions that establish ethical norms of behavior and transparency in government and the private sector, set and enforce legal rules, develop and sustain appropriate macroeconomic policies, liberalize trade and finance, protect property rights, and privatize the ownership of state enterprises and land. The World Bank points out that efficient markets require agricultural institutions that allow ownership and transfer of land and access to financial resources and agricultural technology, and that promote innovation; institutions for the governance of firms and application of business laws; financial institutions that enhance access to investment and operating capital; political institutions that develop policy, promote judicial efficiency, and effective regulation; and formal and informal social institutions through which people and groups can interact.<sup>36</sup>

### **Initiating and Sustaining Macroeconomic Reform**

Governments in those countries seeking to expand their international trade and investment, create jobs, increase incomes and wealth, and improve the standards of living for their citizens must find ways to create a domestic economic system in which most or all goods are available for purchase or sale on the market. Governments can help make markets competitive by allowing prices to reflect true relative scarcities in the economy, encouraging



decision-makers to behave according to rules of the market, and allowing producers to obtain fair profits. In most countries this means finding effective ways of implementing structural adjustment policies, liberalizing trade and investment, creating or strengthening property rights, and developing a legal framework for economic transactions.

### **1. Implementing Structural Adjustment Policies**

Governments in most countries periodically make structural adjustments that enhance the financial viability of productive enterprises. Such policies aim at establishing a system in which private enterprises survive or fall on the basis of profit-making capability rather than on central government plans, bureaucratic controls, and budgetary support, and that are penalized for inefficient or unprofitable activities by the possibility of bankruptcy or liquidation.

Macroeconomic adjustment policies encourage the development of market mechanisms that can efficiently and effectively allocate scarce economic resources and set prices for both production inputs and consumer goods. This often requires financial liberalization and the reduction (and eventual elimination) of price controls. Macroeconomic adjustment policies seek to change the economy's structure of production and consumption by increasing the efficiency and flexibility of producers and consumers to respond to market signals.

By encouraging interaction through market competition macro-economic reforms establish a process in which firms are free to enter and leave the market based on their profitability. Policies promoting market competition should prevent excessive collusion through antitrust laws, reduce barriers to entry, and eliminate marketplace impediments to competition. At the same time, those countries that face serious problems of inflation and decline in national output must enact economic stabilization policies aimed at reducing balance-of-payments

deficits, rescheduling debt, controlling the money supply, reducing subsidies, and restraining wage increases.

## **2. Liberalizing Trade and Opening the Economy to Investment**

The effective operation of competitive market economies requires governments in all countries to adjust their trade and investment policies in order to become or remain competitive. Promoting export competitiveness, as UNCTAD emphasizes, involves “diversifying the export basket, sustaining higher rates of export growth over time, upgrading the technological and skill content of export activity and expanding the dbase of domestic firms able to compete internationally.”<sup>37</sup> Liberalization of trade laws and regulations and the enactment of more favorable investment policies have become crucial aspects of structural reforms. Reforms generally aim at developing the capacity to expand export markets and engage more effectively in foreign trade and investment. This requires liberal trade and investment policies including programs for export promotion, foreign direct investment, exchange rate adjustments, and the easing of investment restrictions and trade barriers.

The importance of developing international trade and investment capacity is seen not only in the challenges facing regimes in developing and transitional countries but also in the pivotal role that foreign trade has played in the history of established market economies. In the West, the extension of trade and the freedom of a merchant class to engage in trade substantially expanded economic opportunities.<sup>38</sup> It allowed new products and commodities to be introduced into the domestic economy (that were later produced locally or transformed into yet other products that found both domestic and overseas markets), and provided consumer goods for which no local or national source yet existed. Innovation by extension of trade and the discovery of new resources has been a major source of creativity and profitability for enterprises and for

their suppliers and distributors in the West and will continue to be a driving force of economic growth in market economies in the future.

National competitiveness increasingly depends on the willingness and ability of governments to participate in regional trade agreements – free trade areas, customs unions, common markets or economic unions. Since the 1970s countries have been expanding their international trade by cooperating in regional trade alliances such as the North America Free Trade Agreement, the Association of Southeast Asian Nations, the Arab Common Market, the Southern Africa Customs Union, and the European Union.

National trade policies are influenced increasingly by international trade agreements. These trade agreements are the international "rules of the game" by which nations and industries must play in order to build competitive advantage. Standards set by the World Trade Organization (WTO) not only attempt to move toward a freer world trade regime but also assess trade penalties against member nations that violate the agreements. Increasingly, a country's international competitiveness be determined by the pace and degree to which national policies are made to conform to international rules of the game for trade and investment. The major provisions of the WTO agreements reduce tariffs by member countries, prohibit them from using health and safety standards that have no scientific basis to restrict trade, and eliminate import quotas.

### **3. Creating or Strengthening Property Rights**

One of the most important institutions for market development and national competitiveness is a reliable system of property rights that facilitates property ownership and its transfer. In many developing countries, the lack of property rights results in “common pool” problems; resources or assets are overused and eventually depleted because there are no limitations on their use.

Without an effective system of property rights a country's resources can be allocated inefficiently, private agents can bribe officials to grant them preferential use of property, bureaucrats engage in rent-seeking behavior, intellectual property developed through innovation can be difficult to protect by those who invested in its creation, and common property is often depleted.<sup>39</sup> The lack of enforceable private property rights in many countries allows state-owned (common or collectivized) property to be misused, abused, over-used or to go unused, leading to inefficient resource allocation.

The institutional components of an effective property rights system include rules for asserting claims of ownership, recording ownership, the types of property that can be publicly and privately owned, settling ownership disputes, and acquiring title to property that has been lost, abandoned, or improperly acquired.<sup>40</sup> An impartial, comprehensive, stable, and efficient body of contract law must be created to institutionalize these rights. Many developing countries are still in the early stages of privatizing state-owned assets and enterprises. They are far from establishing effective rights to property (both real and intellectual) and its use for productive purposes. Yet, without these institutional protections of property achieving the benefits of deep integration that results from direct foreign investment and the meshing of factors of production around the world is difficult if not impossible to achieve.

### **Strengthening Legal Institutions for Economic Transactions**

Establishing and enforcing a “rule of law” -- that is, providing a reliable legal framework for business transactions -- gives participants in market economies the guidelines to operate efficiently and effectively and a framework for protecting natural resources and ecological systems. Without a transparent system of business laws, owners and managers of enterprises waste time and money negotiating each transaction with government officials – a process that

opens the way for bribery and corruption. Business laws provide rules for structuring and organizing corporations, identifying the activities in which they can engage, defining the nature and characteristics of legitimate business practices, and clarifying corporations' rights and obligations. Either by national law or by international agreement, legal institutions should set the standards for treatment of foreign-owned or multinational corporations.<sup>41</sup> They should determine allowable levels of foreign ownership of joint ventures and identify conditions of business entry and exit, including visa restrictions on non-citizens for doing business in the country, business registration, liquidation and bankruptcy, and import and export requirements.

In addition, markets depend on legal institutions to establish and enforce product and pricing standards, anti-trust laws and regulations on restrictive business practices, securities and exchange regulations, rights of access to credit and capital, regulation of bank operations, and guidelines for viable contracts and adjudication of disputes are all essential market institutions. Labor laws establishing legal working conditions, hours, and minimum wages, and obligations of workers and employers are essential to reduce complaints by governments in other countries of “social dumping” or exploitation of women and children.

An institutional structure for business support should include regulations of product and pricing standards; access to credit and capital; and ownership requirements including allowable levels of foreign ownership of joint ventures. An effective system would also include securities and exchange regulations, antitrust laws and competition regulations, contract laws, and regulations concerning commercial litigation and dispute settlement. Labor laws establishing legal working conditions, hours, and minimum wages, and obligations of workers and employers are essential parts of an effective legal framework for business. In most market economies, the legal system for business sets out regulations concerning the sale and management of

commercial real estate, corporate tax rules and exemptions, and licensing and permitting regulations.

National competitiveness in international trade also depends on a set of legal standards ensuring fair treatment of foreign investors, including those for rules on admission, entry, and establishment of foreign firms and general standards of national treatment or fair and equitable treatment. Governments should also create effective mechanisms for the transfer of capital and profits and for dispute settlement through local courts or international arbitration.<sup>42</sup>

### **Implementing Policies that Support Business Development**

Creating or strengthening market economies and national competitiveness requires governments to enact and implement policies that help expand the private sector. Governments can privatize state-owned enterprises, enact policies that facilitate developing small- and medium-sized enterprises, and create conditions that attract, develop, and expand transnational corporations. Enterprises of all sizes must learn to respond to greater market fragmentation, shorter product cycles, smaller production runs, and faster redesign and production of customized goods because all processes of business are affected by technological advances in communications and transportation. The growth of the Internet and electronic commerce requires manufacturing and service firms that wish to compete internationally to become more flexible in their operations; use advanced technology to produce high-quality, reasonably priced goods; adopt speed-to-market methods of operation; use multi-site locations; manage just-in-time production and delivery systems, and engage in world-wide sourcing of goods and services.<sup>43</sup>

#### **1. Privatizing State Enterprises**

An immediate challenge facing most former centrally-planned economies is to privatize and restructure their state-owned enterprises (SOEs). Privatization of state-owned enterprises has

become an important instrument of economic transition and development.<sup>44</sup> Privatization became more attractive with increasing evidence that many state-owned enterprises were loss-makers rather than revenue generators.<sup>45</sup> The heavy demands of SOEs for capital have squeezed private investors out of capital markets in some countries, and in others limited the private sector's access to borrowing for investments that could generate jobs, income, and public revenues.<sup>46</sup>

Financially-strapped governments in both Western industrial nations and developing countries use privatization as a means of generating revenues and of reducing their budget deficits. The worldwide value of one form of privatization -- public and private sales of SOEs -- alone grew from about \$25 billion annually in 1990 to more than \$161 billion in 1997.<sup>47</sup> From 1990 to 2000, SOEs valued at nearly \$1 trillion were transferred from government to the private sector.<sup>48</sup> Substantial privatization will continue to take place in Central and Eastern Europe, South Asia, Southeast Asia, Central and South America, and Africa over the next decade.<sup>49</sup> Privatization continues to be an instrument for reducing inflation by promoting investment of savings in SOEs and for reducing external debt by attracting foreign capital investment in privatized firms. In some former socialist countries, privatization is a means of restructuring the political system by separating economic and political decision-making. In many developing countries privatization is essential for reallocating public resources from subsidies for SOEs to investment in infrastructure and social programs; for increasing the size and dynamism of the emerging private sector; for distributing ownership of SOEs more widely; and for promoting both foreign and domestic private investment. Moreover, privatization can generate the revenues needed by the state to create new jobs for workers displaced by industrial restructuring, reduce the state's administrative responsibilities and the burdens of government intervention in

enterprise management, and provide consumers with more efficiently produced goods. For all of these reasons, privatization continues in both economically advanced and developing countries as an alternative to the expansion of government's responsibilities for the production and distribution of goods and services.

## **2. Promoting Small Enterprise Development**

Simply making macroeconomic adjustments and privatizing state-owned enterprises do not ensure that market economies flourish or that developing countries become competitive. Market economies require a steady supply of entrepreneurs and small business owners to produce goods and services. Developing small businesses is crucial for creating competitive economies. However, new enterprises face overwhelming challenges in surviving and expanding in many countries. Studies in 32 developing countries indicate that many have highly complex administrative procedures for establishing and operating businesses that prevents or delays entry of new enterprises and discourages flows of foreign direct investment.<sup>50</sup> The International Finance Corporation points out that in many countries governments can play an important role in making the environment more conducive for the expansion of small and medium sized enterprises. They include: 1) reducing barriers to entry and eliminating non-competitive behavior, 2) reducing the expense and time required to meet regulatory requirements for licensing and registration, 3) reducing official and unofficial levies that undermine small business' growth and survival, 4) enacting a legal framework for commercial transactions and dispute settlement, 5) enforce laws protecting business and intellectual property; 6) reform tax structures that discriminate against small enterprises, 7) revise government procurement policies that discourage or eliminate small firms from bidding, 8) reduce labor market rigidities that limit



the flexibility of small firms in hiring and firing workers, and 9) provide infrastructure that provides access for small firms to information and markets.<sup>51</sup>

The expansion of small enterprises and their ability to generate jobs depends ultimately on national economic growth and on government policies that create an environment conducive to private enterprise development. Governments seeking to strengthen their market economies should therefore implement reforms that allow markets to expand and operate more efficiently, including effective fiscal and monetary policies, legislation that offers investment incentives, efficient market mechanisms and competitive practices, and appropriate pricing policies for basic commodities and services. But it is also important to enact incentive-oriented wage policies and merit reward systems, stabilize exchange rates, and enact tax and incentive programs to encourage domestic saving and develop financial markets. Moreover, demand-side policies that increase the purchasing power and income of consumers of informal sector products, expand subcontracting and piece-rate work between formal and informal sector firms, and give small firms equal footing in public procurement, could substantially assist small business development.

Supply-side policies are also important. Governments have a crucial role in providing credit for operating small and micro-enterprises, training informal sector owners and workers in better management practices, and creating trade organizations and cooperatives to promote the interests of small enterprises both in procuring supplies and in selling their products. Governments can also help to develop technologies used by informal sector firms, and pass and implement laws that improve working conditions for informal sector participants and enhance the prospects for small enterprise expansion. Supply-side and demand-oriented policies must complement and reinforce each other.

In many countries, ambiguous and rapidly changing government policies and regulations are serious obstacles to small enterprise expansion. The World Bank's survey of 3,600 firms in developing countries found that entrepreneurs in some countries live in constant fear of "policy surprises."<sup>52</sup> A majority of firms in Central and Eastern Europe, Latin America and Africa reported serious negative impacts on their businesses from unpredictable changes in rules and policies made by governments that did not consult with or inform businesses before the changes were made. In many developing countries, registering small enterprises can take months, forcing them to operate in the "informal sector" and inhibiting their ability to expand. Although governments and international development agencies recognize the importance of SMEs in job creation and wealth generation most international assistance programs remain inadequate, poorly designed, and ineffectively implemented.

### **3. Developing, Attracting, and Retaining Transnational Corporations**

Market development and national competitiveness depend heavily on attracting the investment of transnational corporations (TNCs) and on creating a business climate that encourages privatized enterprises and small- and medium-sized businesses to become more actively involved in international trade and investment. Studies in Central and Eastern Europe indicate that increases in foreign direct investment by TNCs help developing countries integrate into international production and marketing networks, provide opportunities for small- and medium-sized companies to become suppliers to international companies and bring technology and managerial experience that can spread throughout industry.<sup>53</sup> As The United Nations Conference on Trade and Development points out "the competitive advantage of resource-intensive, low-cost, low-skill activities declines, countries must be able to attract higher value FDI. If they fail to do so, they will pay the price in terms of slower economic growth."<sup>54</sup>

All enterprises, large or small, that do business across national borders are transnational. The more TNCs a country has and the more successful they are in trade and investment, the more globally competitive the national economy is likely to become and the more likely it will be to grow. As noted earlier, TNCs are playing a critical role international trade and investment, in global economic integration, and in national economic development in many of the industrialized and market-oriented developing countries. TNCs are now a driving force of global economic integration. The strategies of parent firms often progress from simple integration strategies in which affiliates provide inputs to the parent firms, to stand-alone strategies that involve one-way links based on ownership, finance, and technology, and to complex integration in which parent firms and affiliates benefit from economies of scale, increasing revenues from exports, and increasing market share by locating business activities in many countries around the world.

Attracting investment by TNCs requires a business climate that is liberal, open, and relatively unrestrictive. International business experts emphasize that the most important conditions for investment that transnational corporations seek in foreign countries include economic and political stability; certainty in the rules affecting foreign investors; low barriers to trade and financial movements; and a significant role for domestic private enterprise vis-a-vis state-owned enterprises. TNCs prefer countries in which there is a minimum of government intrusion in business operations and decisions and reasonable protection against foreign competition. They seek countries in which governments provide appropriate infrastructure and priorities for development and accept international business and investment laws.

### **Improving Government Efficiency, Accountability, and Responsiveness**

The roles of government in creating the institutional structure for market systems are clear. The Asian Development Bank points out that good governance rests on fundamental principles:

accountability, transparency, predictability, and participation.<sup>55</sup> The emerging global market economy requires governments to provide high-quality services through responsive organizations that meet citizens' needs with a minimum of corruption. In established market economies the public demands better services at lower cost. In countries seeking to increase the competitiveness of their businesses and industries in world markets political leaders must respond to increasing demands for stronger business support services and infrastructure. As a result, governments in many countries are attempting to control corruption and establish ethical norms for economic transactions, undertaking extensive administrative and civil service reforms, and decentralizing and democratizing administrative and political institutions.

### **1. Controlling Corruption and Establishing Ethical Norms**

Among the most important institutions required in market economies are those that disseminate, inculcate, and reinforce ethical norms of behavior. The absence of appropriate ethical norms undermines the operation of market economies, which depend ultimately on public trust and responsible behavior in business transactions.<sup>56</sup> Although individuals and enterprises in market systems are expected to act self-interestedly to maximize profits, the effective functioning of markets requires participants to act responsibly toward each other. In open economies, companies that cheat their customers and suppliers, attempt to eliminate their competitors, and abuse their employees are quickly driven from the market. If governments or societies condone or protect socially irresponsible behavior, it undermines public confidence in both the political and economic systems. Socially-and culturally-determined rules and ethical norms generally define the limits of acceptable behavior and unless those rules are clearly established and effectively enforced the presumption of trust on which market interactions depend quickly erodes. Transparency International's "Corruption Perceptions Index 2002"

found that 70 percent of 102 countries 90 surveyed did not achieve a score above 5 on a 10-point scale (10=least corrupt, 1=most corrupt).<sup>57</sup>

Widespread corruption in public and private transactions is one indication that in many developing countries institutions for enforcing ethical norms are weak. Corruption is reflected in bribery, extortion, influence-peddling, nepotism, kick-backs, rake-offs, speed-money, compliance fees, fraud, falsification of reports or applications, conflicts of interest, extravagance with public funds, favoritism in purchasing contracts, collusion, protection rackets, smuggling, and thievery.

Widespread unchecked corruption seriously weakens or destroys people's trust in public policies and the operation of markets because it undermines the "arm's length" relationship and the checks-and-balances between government and the private sector on which transactions in market systems should rely.<sup>58</sup> Pervasive corruption has toppled governments or tainted ministries in countries where it became pervasive. Although developing countries have no monopoly in corruption they, unlike most Western countries, often lack the institutional arrangements for uncovering and punishing it or for keeping it in check. It is so pervasive in the government bureaucracy and in the private sector of many developing countries that the World Bank and the IMF have attempted to calculate its costs as a means of persuading governments to take more effective countermeasures. The International Monetary Fund estimates the amount of money involved in only one form of corruption, money laundering, is equivalent to two to five percent of world's gross domestic product.<sup>59</sup> Corruption wastes resources and seriously damages the prospects for economic progress in the developing world. Widespread corruption hampers efficient market decisions, reduces returns to investment, and impedes foreign capital inflows. It

makes public investments in infrastructure more expensive and it skews the assignment of tax revenues toward economically nonproductive and socially inequitable activities.

Studies of corruption in countries in transition to market economies have found that it can be reduced by lowering barriers to entry of new businesses, improving the effectiveness of the legal system and increasing competitiveness of services provided by infrastructure monopolies. Strong market institutions, clear and transparent rules, fully functioning checks and balances, fair enforcement of regulations and a competitive environment reduce the opportunities for corruption. Local non-government organizations (NGOs) can also help identify the sources of corruption, publicizing them, encourage transparency and accountability, and create alliances with international organizations to carefully observe government decisions that involve potential corruption. Ultimately, however, ethical norms must be established, disseminated, accepted, and reinforced through politically accepted legal institutions and social organizations, and enforced by government.

## **2. Making Public Administration More Responsive**

Creating or strengthening a market economy often requires governments to change the way they operate. In a market economy, governments cannot monopolize political power or service provision. Usually they must rely heavily on the participation of private and NGOs to provide services effectively and efficiently. The rapidity of changes resulting from globalization and technological advances require government agencies to restructure and to manage in less bureaucratic fashion. Governments organized functionally are often too inflexible and isolated to respond effectively to public needs. Government agencies must collaborate with other institutions and delegate operational responsibilities to lower levels in the organization.

Governments must persuade and motivate citizens to secure their allegiance and act as consensus makers to get stakeholders to work together in common cause.<sup>60</sup>

Market development and national competitiveness require effective public administration and civil service systems. Such systems must be able to attract qualified, competent, honest, and realistically paid individuals into public service. If domestic and international investors are to have confidence in a country's economy the government must have a civil service system that relies on merit-based recruitment and promotion, incentive-based compensation, and clearly defined reward-oriented career paths. The civil service must be able to attract and retain a corps of professionals who are responsible for formulating and implementing economic policies and support them with good training, an appropriate degree of independence, and professional reward structures. Professional civil servants must be protected from inappropriate political interference in carrying out their responsibilities. The civil service should also be given enough flexibility to facilitate communications between the public and private sectors.

In order to achieve these goals and make government more responsive to changing needs and demands, the civil service must recruit using common selection criteria, appointments based on merit, and protection from inappropriate political influence. Senior officials should be given adequate authority to manage their responsibilities for delivering services and for providing policy advice to political leaders. Managers should also be given adequate authority to make appropriate technical and administrative decisions without central approval; to create and abolish positions; to appoint, promote and transfer staff; and to deal directly with most other personnel management issues in their departments. Although difficult and slow to change in most countries, civil services in market economies must become more efficient, effective, responsive, and accountable if governments are to play a positive role in economic development.

### **3. Strengthening Judicial Institutions**

In many countries governments must not only strengthen their administrative and legislative branches but also establish an effective judiciary. The promulgation of business laws without strong enforcement or judicial institutions renders legal guidelines meaningless. The World Bank found in a survey of 3,600 firms in developing countries that 80 percent of entrepreneurs in Latin America, Sub-Saharan Africa, Central and Eastern Europe, and the former Soviet Union expressed “a lack of confidence that the authorities would protect their person and property from criminals.”<sup>61</sup> More than 70 percent of the entrepreneurs complained that “judicial unpredictability was a major problem in their business operations.” Strong judicial institutions assure that private citizens and corporations have equal access to legal procedures for redressing grievances and obtaining reasonable and timely resolution of disputes. Judicial institutions enforce business and civil laws, offering adequate remedies for wrongs determined through litigation. Strong and independent judicial institutions have competent and impartial judges; adequate physical facilities, management, and records maintenance for courts; and court procedures that are balanced, fair and guided by principles of due process, rules of evidence and discovery of evidence. Creating and enforcing a set of legal standards ensuring fair treatment of foreign investors, including those for rules on admission, entry, and establishment of foreign firms and general standards of national treatment facilitate a country’s participation in international trade and investment.

### **4. Decentralizing Government**

Creating or strengthening market systems requires governments to democratize the political system and expand managerial capacity in public institutions. Economic problems often arise from the over- concentration of control in the central bureaucracies over public services and



infrastructure. Some countries require more decentralized administrative and political systems in order to perform their functions and implement economic development policies more effectively.<sup>62</sup> To the extent that the ability of their enterprises and industries to compete successfully in global markets and to generate profits depends on the availability and quality of support services and physical infrastructure, highly centralized governments may be less effective in creating a conducive business environment than governments that are more decentralized and able to respond quickly to changes in local needs and conditions. Governments in industrial, transitional, and developing countries all face challenges in determining the appropriate allocation of functions and responsibilities among central governments, local governments, and the private sector. Governments in transitional and developing countries have the opportunity to strengthen administrative capacity through decentralization.

Administrative decentralization seeks to redistribute authority, responsibility and financial resources for providing public services among different levels of government.<sup>63</sup> Administrative decentralization can be defined as the transfer of responsibility for planning, management, and the raising and allocation of resources from the central government and its agencies to field units of government agencies, subordinate units or levels of government or semi-autonomous public authorities or corporations, area-wide, regional or functional authorities.

Most governments in developing countries decentralize through deconcentration or delegation. Deconcentration redistributes decision-making authority and financial and management responsibilities for providing services and facilities among different levels of the central government, that is, to central government officials posted in regions, provinces or districts.<sup>64</sup> Delegation is a somewhat more extensive form of decentralization. Through delegation, central governments transfer responsibility for decision-making and administration of

public functions such as education or health services to semi-autonomous organizations not wholly controlled by the central government, but ultimately accountable to it. Governments delegate responsibilities when they create public enterprises or corporations, housing authorities, transportation authorities, special service districts, semi-autonomous school districts, regional development corporations, or special project implementation units. Usually these organizations have a great deal of discretion in decision-making. They may be exempt from constraints on regular civil service personnel. They may be able to charge for their services and may be operated like private corporations, using business practices and procedures.

In most countries that seek to create an efficient and competitive market economy, national governments must strengthen the administrative, financial and legal status of local governments, and especially those of cities. This may require devolution, another form of decentralization. When governments devolve functions, they transfer authority for decision-making, finance and management to autonomous units of local government with corporate status. Devolution involves transferring responsibilities for services to municipalities that elect their own mayors and councils, raise their own revenues, and have independent authority to make investment decisions.

### **Providing Physical and Technological Infrastructure**

Modern and efficient physical and technological infrastructures are preconditions for national, regional, and local economic growth and channels through which private enterprise participates in domestic and international trade. Experience suggests that physical infrastructure is a necessary but not a sufficient condition for promoting economic diversification and strengthening productive enterprise. Economic infrastructure and the services it provides include: public utilities (power, telecommunications, piped water supply, sanitation and sewerage, solid

waste collection and disposal, and piped gas); public works (including roads and major dam and canal works); and other transport facilities (including urban and interurban railways, urban transport, ports and waterways, and airports). More importantly, in a global economy driven by technological innovation, governments must play an increasingly crucial role in establishing and sustaining technological infrastructure.

The Commission of the European Communities concludes that among nations and regions having similar location, population concentration, and sectoral structure endowments, those with better physical infrastructure achieve higher levels of income, productivity, and employment.<sup>65</sup> Insufficient or poor quality infrastructure creates bottlenecks for development and limits the capacity of local enterprises to benefit from location advantages or to change the sectoral mix of the regional economy. Investments that improve infrastructure can also overcome some of the limitations of unfavorable location or low levels of population concentration.

An efficient system of services and infrastructure also enhances the efficiency of private capital. Entrepreneurs and managers are more likely to be attracted to regions with better social services and physical facilities where they can make use of the other production factors more effectively. Regions with insufficient infrastructure suffer not only from bottlenecks, but also from not being able to attract and maintain mobile factors of production and to pay competitive remuneration for entrepreneurs and labor.

Relentless technological innovation, especially in globally interconnected digital communications, transportation, and business logistics systems, has spawned the rapid growth of service and manufacturing industries linked through virtual networks and supply chains, and is increasing the demand for rapid delivery of high quality goods, services, and information in

North America, Europe, Asia, and Latin America. Rapid advances in information technology and electronic commerce are fundamentally changing the demands on businesses and revolutionizing the way they conduct transactions.<sup>66</sup> Advances in digital communications technologies are driving down the costs and increasing capacity for exchanging information. As technology-based manufacturers increasingly adopt advanced computer systems and robotics to do simulated product design, virtual prototyping, concurrent or simultaneous engineering, and motion planning to reduce design and production cycles and increase their flexibility in meeting customer orders, they need more advanced communications infrastructure local area networks and wide area networks.

Globally competitive businesses require more than analog switched copper line-based telephone systems; they have increasingly come to depend on infrastructure that allows mid-band and broad-band access for a wide range of communications and Internet equipment. Fiber-based cable, satellite, and cellular communications infrastructure will be essential to connect companies to their customers and suppliers and to their own branches, offices, subsidiaries and partners. Communications and transportation infrastructure offer more firms and industries the capacity to develop larger markets that extend beyond national borders to satisfy worldwide demand for new products and services. In order to cope with the rapidly changing trends in the international economy, governments must provide the infrastructure and services that businesses of all sizes need to respond more quickly to the rapidly changing needs of their customers.

### **Protecting the Economically Vulnerable**

Governments in market economies have a vital role in protecting economically vulnerable segments of the population from catastrophic impacts at least until they are able to participate productively in market activities. By the mid-1980s studies began to show that

International Monetary Fund and World Bank prescriptions for structural adjustment had mixed impacts on the economies of developing countries and short-term negative effects for the poorest populations.<sup>67</sup> Although the transformation to a market-oriented economy brought great economic and political benefits to many former planned economies, the transition also resulted in relatively high levels of unemployment, especially among lower-skilled, less- educated and long-time employees of state enterprises and drastic declines in gross domestic product ranging up to 40 per cent in some countries in the years immediately following macroeconomic reforms. Transitional countries saw an increase in poverty that was related both to unemployment and unfavorable temporary economic conditions. Many countries experienced a deepening of income inequality as private entrepreneurs and professionals gained in income and wealth relative to the rest of the population.

Some of the most serious problems arose because governments and international assistance organizations paid little attention to the social consequences of the reforms. As state enterprises were privatized and restructured, their modernization brought drastic changes in the conditions of employment, especially in former socialist countries. Wages became more closely linked to individual and group performance rather than to occupational classifications, employees had to become more flexible in their work times or accept part-time work, and advancement depended on developing multiple skills and a willingness to take on multiple tasks required in companies that had to adjust rapidly to customer demands.

From the transition experience in East and Southeast Asia, the Asian Development Bank concluded that governments seeking to provide social protection to the economically vulnerable segments of the population during transition and cyclical downturns should focus on five areas:

- 1) labor market policies that help generate employment and ensure efficient operation of labor

markets; 2) social insurance programs that mitigate some of the risks associated with unemployment, disability, ill-health and old age; 3) social assistance and welfare service programs for those groups such as single mothers, the homeless or physically and mentally challenged people who have no other adequate means of support; 4) micro-and area-based projects that address causes of vulnerability within communities by providing access to micro-insurance, agricultural insurance social funds and disaster relief, and 5) child protection programs that ensure healthy and productive child development.<sup>68</sup>

Among the most important components of a social safety net policy for protecting the economically vulnerable segments of the population are protecting the pension systems where this is the primary or sole source of cash incomes for those who are too old to work and creating or maintaining reasonable unemployment benefits for those workers who are released from their jobs in state enterprises, or laid-off because of restructuring after privatization, or are in the process of changing employment. Governments must also help in establishing and maintaining a system of private health and social insurance to replace those provided in state enterprises for workers who face loss of short-term income because of health contingencies and in maintaining social assistance programs for the disadvantaged who are adversely affected by economic transition.<sup>69</sup>

In order to create an efficient and effective system of social benefits, eligibility requirements must be carefully designed to protect all of those who are in the most vulnerable groups. Benefits must be set at levels that are within the limits of available government resources and that foster development of the private sector and competition.

Governments in most developing countries also face strong challenges in alleviating widespread poverty. Poverty undermines social cohesion, political stability, and economic

productivity. Market economies require a productive workforce drawn from a healthy, educated, and skilled population. The United Nations Development Programme notes that in order to alleviate poverty, governments and the private sector must take actions to prepare the poor to participate effectively in the economy.<sup>70</sup> This requires increasing the access of the poor to basic education and health services.

Governments must enact agrarian reform policies that give the rural poor a more equitable distribution of land and agricultural resources and open access to credit for the poor by changing criteria of creditworthiness and decentralizing credit institutions. Governments can play an important role in expanding productive employment opportunities and sustainable livelihoods for those who are unemployed or underemployed and increasing the participation of the poor in the development and implementation of poverty-alleviation policies and programs to assure that they are needed and appropriate. In developing countries it is especially important for governments to provide an adequate social safety net to protect those excluded temporarily or permanently from the market while pursuing policies that promote economic growth and increased productivity so that new opportunities are available for the poor to improve their living standards. As development accelerates, government can work closely with the private sector to increase people's capacity to use resources in a sustainable and environmentally-beneficial manner.

### **Strengthening and Supporting Institutions of Civil Society**

Globalization has had a strong impact on strengthening organizations of civil society in many countries with previously authoritarian regimes according to studies carried out by the Economic and Social Commission for Asia and the Pacific.<sup>71</sup> “Certain aspects of globalization

greatly favor the creation of new associations and interest groups in societies as well as networks of them to offer mutual support and resources,” ESCAP points out. “Such cooperation is particularly visible in fields such as environmental protection, equality for women and human rights.”

While globalization facilitates the development of civil society organizations, promoting a robust network of social and civic institutions – commonly referred to as “social capital” – seems to be essential in most countries to the effective operation of markets, national competitiveness and economic growth. Social capital has powerful consequences because civic networks and norms ease the dilemmas of collective action by institutionalizing social interaction and reducing opportunism, by fostering norms of social reciprocity and social trust, and by facilitating political and economic transactions.<sup>72</sup> Well-developed networks of civil institutions also amplify the flows of information and help transmit knowledge of people’s reputations that lower economic and social transaction costs. They offer channels for reliable political, economic, and social collaboration.

Among the most important institutions of civil society are employers organizations; industry associations; commercial associations; labor unions; employee groups; professional associations; policy and advisory groups; a free press, television, and radio; gender, language, religious, and other social-interest groups; and community and neighborhood groups. As societies become more complex people also need the help of consumer groups, charitable and philanthropic organizations, and social organizations that bring them together to participate in a wide range of activities from sports and recreational endeavors, to music, art, handicrafts, hobbies, or other forms of social interaction. All of these groups, by bringing people together in



common cause, provide them with mechanisms for contributing to the quality of life in their communities and countries.

Institutions of civil society can make powerful contributions to life support systems, especially in countries where civic networks were not encouraged and social capital was allowed to decay. Civic organizations can help offset or mitigate the adverse effects of market weaknesses and market failures. Institutions of civil society also play crucial roles in providing functions and services that the market cannot offer. They have especially strong impacts on economic, political and social development when they work in cooperation with each other, the government, and the private sector. They can contribute to economic development by helping to create an “entrepreneurial milieu” so essential to sustaining a market economy, by working with other institutions in developing human resources, by protecting the economically weak segments of the population from the potentially adverse effects of economic transformation, and by participating in activities that help alleviate poverty.

## **CONCLUSIONS**

Market systems are the engines of national economic growth and the means through which private enterprises become competitive in a globalizing economy. To operate effectively, however, market systems require a strong institutional framework. Globalization and the technological innovation that drives economic, social, and political interaction across national boundaries can bring substantial benefits to people in countries where governments focus on enacting and implementing market-supporting policies and creating and sustaining the institutions needed to make markets open, equitable and competitive. Studies of countries that have gone through the transition from closed, planned, controlled economies to open market systems, indicate that successful transformation requires not only economic policy reforms but

also political liberalization.<sup>73</sup> Creating the institutions and policies supporting efficient market systems and facilitating national competitiveness requires long-term political commitments by governments with strong developmental orientations.

States seeking to participate in and benefit from a global market economy must create and sustain institutions that promote or strengthen seven underlying attributes of market systems that make them more open to domestic and international transactions.<sup>74</sup> Governments have an important role to play in strengthening the following attributes: 1) economic motivation – market systems depend on society’s acceptance of material gain and the necessity of business organizations to make profits as a primary motive for individual production and investment; 2) private productive property – in market systems governments must protect private ownership of income and wealth so that those who produce goods and services are adequately rewarded; 3) freedom of enterprise – to employ private property effectively, owners must be permitted to mobilize the resources needed to make it more productive; 4) market-based decision-making – in market systems economic and business decisions must be made by market signals, that is, primarily through consumer decisions affecting supply and demand; 5) competition – which is a basic attribute of market economies, and the primary motivator for individuals and producers to divide labor, specialize, develop comparative advantages, improve quality, cut costs, and innovate; 6) equality of opportunity – “free” markets require institutions that assure all individuals and groups the opportunity to engage in economic activity through the ownership of property and the formation of enterprises, or fair sale of their labor for income; and 7) societal rule setting and guidance – in order for markets to operate efficiently and effectively participants must establish and adhere to institutionalized “rules of the game,” and government must establish a “Rule of Law” and enforce regulations within which markets can function efficiently.

When they operate fairly, effectively, and efficiently market economies facilitate competitiveness and stimulate economic growth, create jobs, raise incomes, provide opportunities for saving and investment, and give people the chance to improve the quality of their lives. Competitiveness in the global economy can generate the income needed for people, businesses, and governments to protect their environment and conserve natural resources, reduce poverty, and enhance human assets. Properly guided, economic growth enables organizations of civil society to work closely with business and government to strengthen the life support systems that improve human conditions and protect the global ecosystem.

## Notes

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